The PERAC Financial Bulletin

Financial Market Review, Second Quarter 2007

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Public Employee Retirement Administration Commission Five Middlesex Avenue, Suite 304, Somerville, MA 02145
Phone 617 666 4446 Fax 617 628 4002 TTY 617 591 8917 Web www.mass.gov/perac

The US stock market surged to new record highs for most of the second quarter before sputtering near the end. Hopes that the economy was approaching a sweet spot of being neither too hot nor too cold began to be challenged in June. On the one hand, a booming world economy was raising inflation fears and dashing hopes of any cut in interest rates. On the other hand, the sagging US housing market was fueling fears of losses in investments linked to home mortgages, particularly the sub-prime sector.

Another concern was that higher rates on junk bonds and investor resistance to issuer-friendly financing terms would cause weakness in corporate buyouts by private equity funds, whose buying power has been fueling much of the market's euphoria.

The GDP growth rate for the second quarter was expected to rise to at least 3% and, although growing at a somewhat slower pace, corporate profits remained strong. While rising oil prices (crude rose to a ten-month high) and unrest in Iraq, Iran, Lebanon, and the Gaza strip weighed on the market, an encouraging employment report for June, which showed healthy job growth and weak wage pressures, may have provided a positive spark as the third quarter began.

Equity Market

Before falling over the final weeks of the month, both the Dow Jones Industrial Average (up 8.5%, its best quarter since the fourth quarter of 2003) and the S&P 500 (having risen in eight of the past nine quarters) reached new all-time highs on June 4, surpassing their previous peaks set in March 2000. The S&P 500 returned 6.3% while the Dow Jones Wilshire 5000 broad market index rose 6.1%. The NASDAQ Composite rose 7.5% but was still barely half its 2000 peak level.

Midcaps trailed large caps for the quarter but have still outperformed them so far this year. In a sign that

Chart 1

S&P 500, 2007: Rally, Then a Sputter In June

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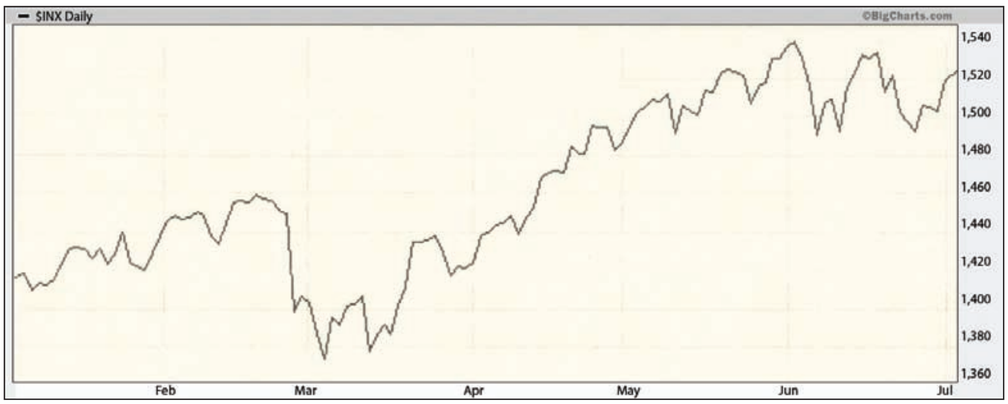

Chart 2

S&P 500, Five Years: The Impressive Rally Continues

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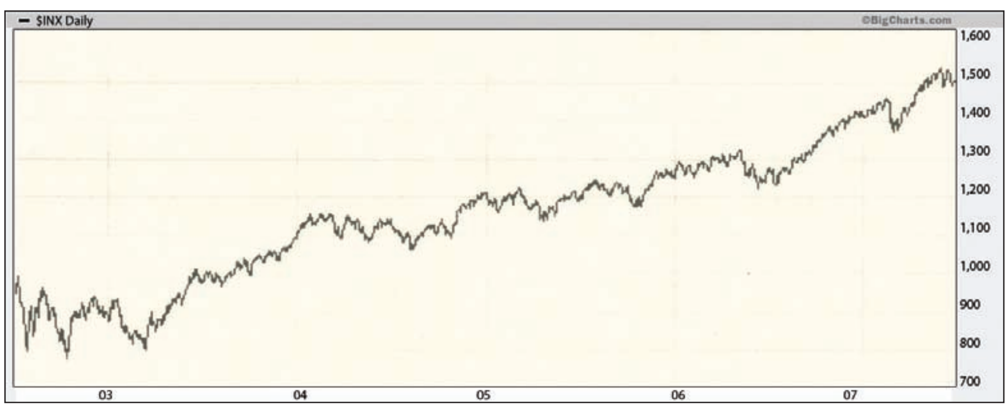

Chart 3

S&P 500, Ten Years: Surpassing Its All-Time High

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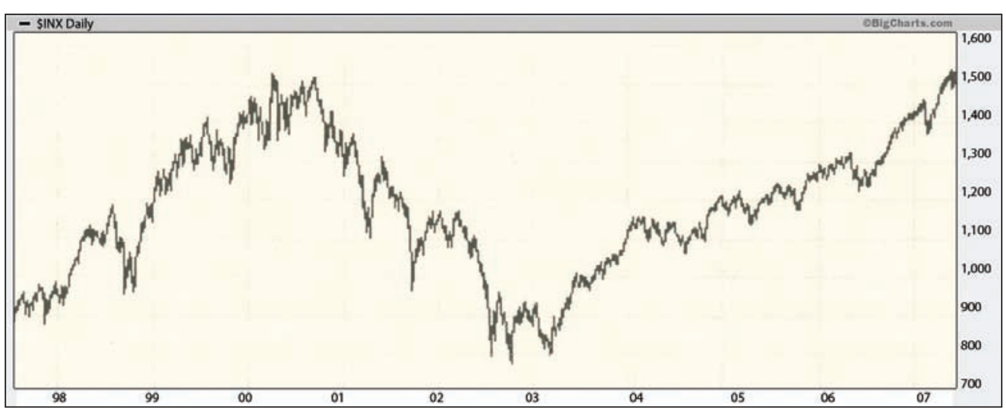

Chart 4
S&P 500 vs. Russell 2000, 2007: Large and Small Caps About Even

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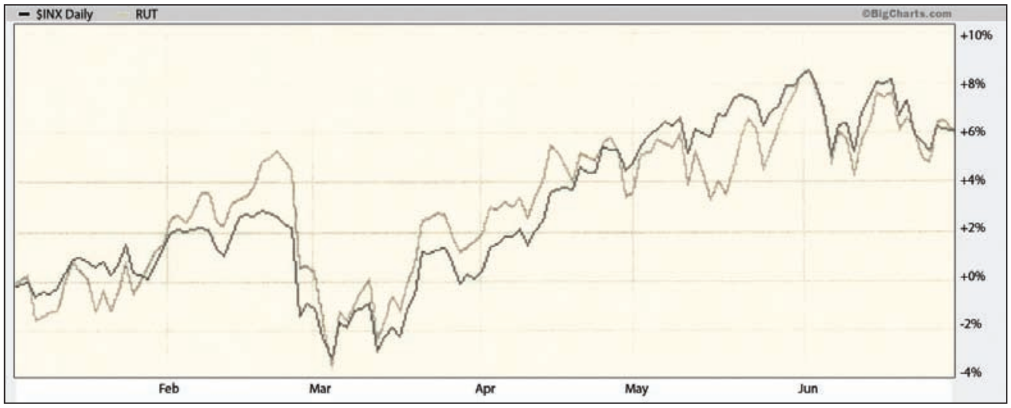

Chart 5
S&P 500 vs. Russell 2000, Seven Years: Small Caps Rule

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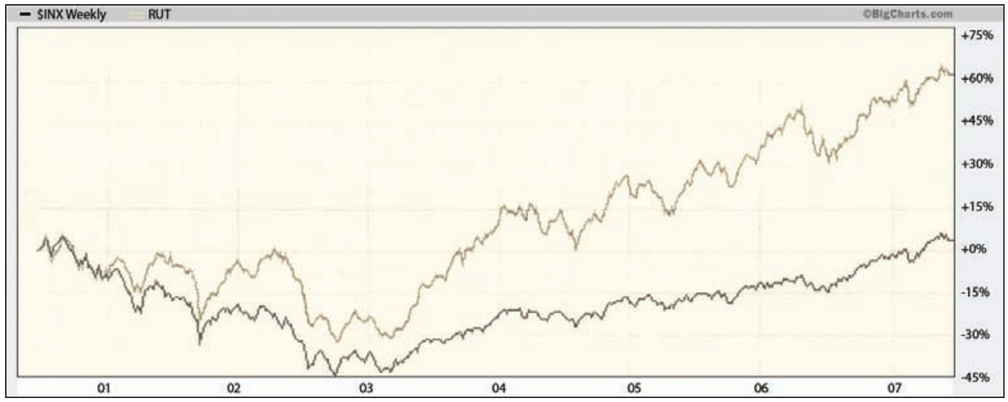

their long period of outperformance has come to an end, small caps trailed large caps for the quarter and are about even year-to-date.

Among the S&P 500's ten industrial sectors, energy (6.6%) and information technology (10.2%) were the best performers for the quarter while utilities (-1.1%) and financials (1.5%) were the laggards. Among the 30 Dow Industrial stocks, Intel (24.2%), General Motors (23.4%), and Honeywell (22.2%) were the second quarter leaders while Procter & Gamble (-3.1%) and JP Morgan Chase (0.1%) were the worst performers.

Robust economic growth and strong corporate earnings helped equity markets all over the world to surge in concert with the US. European countries were helped by strong export demand, corporate restructurings, and merger and acquisitions activity. Emerging markets were helped by robust economic fundamentals and a weak US dollar. Impressive economic growth helped markets in China, Hong Kong, South Korea, and India surge to double digit gains during the quarter while Brazil's strong performance was aided by rising oil prices. For the quarter, the MSCI-EAFE Index rose 6.4% while the MSCI-Emerging Markets index rose 15.0%. Reflecting the effect of the weaker US dollar, the respective returns were 5.9% and 12.5% in local currency terms.

Bond Market

The bond market garnered as much attention as the stock market during the quarter as interest rates rose across the board. Although the Fed voted to keep short term rates unchanged, Treasury note yields increased amid concerns over strong economic growth, inflation fears, and worries that foreign central banks might reduce their holdings of Treasuries. The yield on the benchmark 10-year Treasury note rose from 4.65% to 5.03%, after reaching a five-year high of 5.25% during the quarter. Except for a few exceptions, the yield had been below 5% since mid-2002. Corporate bonds were under pressure amid the heaviest quarterly issuance ever. Mergers and acquisitions contributed to the second highest quarterly issuance ever for junk bonds. At quarter-end, the lower quality debt market was buffeted by the near collapse of two Bear Stearns hedge funds that invested in sub-prime mortgages. As yields rose in all sectors, yield spreads between junk bonds and Treasuries remained historically narrow, indicating that there was still substantial liquidity as well as fundamental optimism in the market. The Lehman Aggregate Index was down 0.5% for the quarter. Benefiting from their higher coupons, high-yield bonds were up 0.3% for the quarter.

Other Asset Classes

The strong stock market carried over into a very healthy climate for Initial Public Offerings. Led by private equity giant Blackstone Group's $4.75 billion offering in late June, the second quarter saw a 22% increase in IPOs over the second quarter of 2006, leading to a 17% increase in the six month totals for 2007 compared to 2006. Subject to market conditions, the third quarter could be even higher for IPO issuance. Reported returns are lagged by several months, but composite performance by private equity and venture capital firms is expected to be strongly positive in line with the general stock market.

Despite the continued weakness in residential housing, commercial real estate has remained strong. In the office sector, strong economic fundamentals, a dearth of space in several major markets, and a proliferation of deep-pocketed landlords who can afford to hold out for premium tenants were leading to lower vacancy rates and/or higher rents. Nevertheless, investment returns were mixed during the second quarter. After annualized returns of 21.1% over the past three years and 18.8% over five years, the publicly-traded REIT market has experienced a correction, falling 5.9% this year. Private real estate — office, retail, industrial, hotel, etc. — continued to show annualized returns in excess of 16% through the end of the first quarter.

As the second quarter ended, Bear Stearns was struggling to salvage two hedge funds impacted by the sub-prime mortgage debacle, but the hedge fund industry remained healthy overall, with composite returns from funds of funds in the high single digits year-to-date. By all indications, money was continuing to flow into hedge funds at a healthy clip.

Outlook

As always, it is important to consider the investment landscape from all perspectives. For stocks, the five year bull market has gone on longer than most previous advances yet stock prices remain fairly valued relative to historical price/earnings ratios. For bonds, interest rates have risen from their cyclical lows but they still remain low by historical standards.

Governor Patrick's legislative proposal on public pension funds demonstrates how important it is for local systems to manage their assets with great care and prudence. When a board has a specific return target to meet, a portfolio that is overly conservative is just as risky as one that is overly aggressive. As we've stressed over the years, boards must work closely and diligently with their consultants to develop a well diversified asset allocation, to hire strong managers, to closely monitor their managers, and to terminate them when it is apparent that they are not fulfilling their mandates. For systems that don't employ a consultant, the PERAC Investment Unit remains eager to provide whatever technical assistance might be requested.

TOTAL RETURNS | SECOND QUARTER, 2007

INDEX	SECOND QUARTER 2007	SIX MONTHS 2007
US EQUITY MARKET		
Dow Jones Industrial Avg.	+ 9.11%	+ 8.76%
Standard & Poor's 500 (Large Cap)	+ 6.28%	+ 6.96%
NASDAQ Composite	+ 7.50%	+ 7.80%
Wilshire 5000 (Broad Market)	+ 6.07%	+ 7.56%
Standard & Poor's Mid-Cap 400	+ 5.84%	+ 11.98%
Russell 2000 (Small Cap.)	+ 4.42%	+ 6.45%
GROWTH VS. VALUE		
Russell 1000 (Large Cap) Growth	+ 6.86%	+ 8.13%
Russell 1000 (Large Cap) Value	+ 4.93%	+ 6.23%
Russell Midcap Growth	+ 6.74%	+ 10.97%
Russell Midcap Value	+ 3.65%	+ 8.69%
Russell 2000 Growth	+ 6.69%	+ 9.33%
Russell 2000 Value	+ 2.30%	+ 3.80%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	+ 6.40%	+ 10.74%
M.S.C.I. - Emerging Markets	+ 14.96%	+ 17.55%
FIXED INCOME		
Lehman Brothers Aggregate Index	- 0.50%	+ 1.00%
Merrill Lynch High Yield Index	+ 0.30%	+ 3.00%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	- 9.04%	- 5.89%
NCREIF Property Index	+ 3.62%	+ 16.60%
	(Q1)	(Trailing 12 months)